SAN JUAN COAL CO.

IBLA 90-482 Decided June 15, 1992

Appeal from a decision of the Director, Minerals Management Service, partially denying an appeal from an order assessing additional royalty for coal production from Federal coal leases NM-045196, NM-045197, NM-045217. MMS-88-0084-MIN.

Reversed.

1. Coal Leases and Permits: Royalties

The applicable regulations for purposes of determining royalty on Federal coal production sold pursuant to an arm's-length coal supply contract during the period 1980-86 provide that gross value shall be the sale or contract unit price times the number of units sold. What constitutes the sale or contract unit price depends on the terms of the contract.

2. Coal Leases and Permits: Royalties

Where separate provisions of an arm's-length coal supply contract provide the sale or contract unit price for separate sources of coal, and the sales price billed the purchaser is merely a sum of all the various contract pricing components, the pricing provision governing Federal coal production is properly utilized to determine the gross value of Federal production for purposes of calculating royalty.

APPEARANCES: Lawrence G. McBride, Esq., Washington, D.C., for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY DEPUTY CHIEF ADMINISTRATIVE JUDGE HARRIS

San Juan Coal Company (San Juan) has appealed from a June 7, 1990, decision of the Director, Minerals Management Service (MMS), partially denying its appeal from a January 11, 1988, order of the Area Manager, Lakewood Area Compliance Office, Royalty Management Program (RMP), MMS, directing San Juan to pay additional royalties for coal production from Federal coal leases NM-045196, NM-045197, and NM-045217.

The relevant facts in this case are not in dispute. In 1980, San Juan entered into a contract with Public Service Company of New Mexico and Tucson Electric Power Company (the Utilities), the operators of the San Juan Generating Station, to supply coal to that station. We will refer to that document hereinafter as the Agreement. San Juan represents that the Agreement is an exclusive supply contract obligating San Juan to deliver all needed coal to the station during the life of the Agreement, and that the Agree-ment contemplated that coal would be derived from more than one source. The Agreement contains separate provisions for computing the amount owed: paragraph 9.2 for coal mined from the Fruitland leases, which are associated with the San Juan Coal Mine and include the three leases involved in this case; 1/ paragraph 9.3 for coal mined from the La Plata leases, which are associated with the La Plata Coal Mine; and paragraph 9.4 for delivered "non-SJCC coal," which is coal that is not mined by San Juan, but is purchased from Sunbelt Mining Company (Sunbelt) and resold to the Utilities by San Juan; and paragraph 9.5 for processing and sizing all coal delivered in the billing period (See Statement of Reasons (SOR) at 4; Reply at 2).

The January 11, 1988, RMP order, which resulted from an MMS audit covering the period from December 1980 to March 1986, instructed San Juan that, although certain deductions were allowed, the total sales price for coal should be "divided by the total number of tons sold to derive the unit sales price. The unit sales price times the number of federal tons sold equals gross value for royalty purposes" for the leases in question (RMP order at 2). RMP found San Juan incorrectly calculated gross value of coal sales from those leases by deducting from gross revenues "the purchase of non-SJCC coal" (Id.). 2/

The Director, MMS, relied on the language of section 9, paragraph 9.1, of the Agreement in affirming RMP's determination of the gross value of San Juan's production from the leases in question:

> Compensation--The sales price for coal delivered to Utilities under this Agreement shall be equal to the sum of (i) the sum of SJCC's Operating Costs, the Capital Investment Element, the Additional Capital Investment Payment and the Administration Component for mining each coal source as provided for in Para-graphs 9.2 and 9.3 and for processing coal as provided for in Paragraph 9.5, (ii) SJCC's costs incurred for non-San Juan coal if any, as provided for in Paragraph 9.4 and (iii) the Efficiency Element as provided for in Paragraph 9.6.

1/ The Fruitland leases also include non-Federal coal leases.

2/ The RMP order further directed San Juan to pay additional royalties because it had improperly deducted from gross revenues its costs associated with coal ash disposal. San Juan also sought review by the Director, MMS, of that issue. The Director reversed the RMP determination concluding that ash disposal was not part of San Juan's mining operation; rather, it was a service that San Juan contracted to provide that was separate from its production and sale of Federal coal. Ash disposal costs are not at issue in this appeal.

The Director accepted RMP's conclusion that the Agreement was an arm's-length contract and that the value for royalty purposes was the "sales/contract unit price" (Decision at 7). Although the Director recognized, as argued by San Juan, that there are separate formulas in the Agreement for calculating the various pricing components, he rejected San Juan's argument that the terms of the Agreement were divisible and that the value of the coal production from the leases in question should be based solely on the pricing provision for the Fruitland leases. Instead, he interpreted the language of paragraph 9.1 to mean San Juan receives "a single price for all coal sold under this agreement, regardless of the source of that coal, and that the sales price is to be the sum of pricing components" (Decision at 6 (emphasis in original)). The Director admitted that because the Fruitland lease pricing component specifically covered the leases in question, that component itself could, arguably, provide a reasonable basis for valuing the subject coal. He rejected that argument, however, concluding that San Juan had failed to establish that RMP's valuation was erroneous.

During part of the relevant period, the valuation regulation read:

> (b) The gross value shall be the sale or contract unit price times the number of units sold, Provided, however, That where the Mining Supervisor determines: (1) That a contract of sale or other business arrangement between the lessee and a purchaser of some or all of the coal produced from the lease is not a bona fide transaction between independent parties because it is based in whole or in part upon considerations other than the value of the coal, or (2) that no consideration is received for some or all of such coal because the lessee is consuming such coal for his own use or adding it to inventories, the Mining Supervisor shall determine the gross value of such coal, taking into account (i) any consideration received by the lessee in other related transactions, (ii) the highest price paid for coal of like quality produced from the same general area during the lease month, (iii) contracts or other business arrangements between coal producers and purchasers for the sale of coal other than coal produced under such lease, which are comparable in terms, volume, time of execution, area of supply and other circumstances, and (iv) such other relevant factors as the Mining Supervisor may deem appropriate * * *.

30 CFR 211.63 (1980). 3/

3/ This regulation was subsequently modified in 1982 (47 FR 33192 (July 30, 1982)) and renumbered as 30 CFR 211.63(g). It was again renumbered as 30 CFR 203.200(g) in 1983 (48 FR 35642 (Aug. 5, 1983)). Neither of these changes is relevant to the issues herein. It should also be noted that even though 30 CFR 211.63(g) was renumbered as 30 CFR 203.200(g) in August 1983, the Department announced, in September 1983, that it was redesignating 30 CFR 211.63(g) as 43 CFR 3485.2(g) (48 FR 41589 (Sept. 16, 1983). Thereafter, during the time period relevant to this case, the language "gross value shall be the unit sale or contract price times the number of units sold" appeared in both 30 CFR 203.200(g) and 43 CFR 3485.2(g).

On appeal to the Board, San Juan argues that the MMS valuation is erroneous because it, in effect, demands computation of a weighted average price for all coal delivered under the Agreement. San Juan charges that the above-quoted regulation cannot support such a construction. First, San Juan points out that the regulation is a Federal royalty regulation. Accordingly, it argues, the unit price referred to therein must be the unit price of Federal production. Under the Agreement, Federal lease production, San Juan asserts, is controlled by the pricing provisions of paragraph 9.2, which pertain to the Fruitland leases. San Juan contends that MMS' valuation does not represent Federal lease production because it requires the averaging of prices of all production, regardless of the source, including the coal that San Juan buys from Sunbelt in order to fulfill its Agreement with the Utilities. 4/

Next, San Juan asserts that the regulation itself prohibits use of a gross value for Federal production higher than the unit price of Federal production. This is so, San Juan charges, because, under the regulation, in order to take into account matters other than the unit price of Federal production, MMS must determine that the contract was not arm's-length, something it did not do in this case. 5/

Finally, San Juan argues that the Sunbelt coal that MMS is requiring be utilized with the Federal lease production to establish the unit price for Federal lease production is not mined by San Juan. San Juan cites Diamond Shamrock Exploration Corp. v. Hodel, 853 F.2d 1159, 1167 (5th Cir. 1988), in support of its contention that "[r]evenue received by a lessee for services or consideration not tied to lease production does not bear a royalty" (SOR at 17). It is that principle, San Juan contends, that the Director utilized in overturning the RPM order requiring San Juan to pay royalties on its revenue from ash disposal (see note 2, supra). Thus, when the Director determined that ash disposal was not San Juan's obligation, he found that San Juan had no royalty obligation. San Juan asserts that, similarly, with respect to Sunbelt coal, San Juan is not producing

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4/ According to San Juan, since the rule governs the determination of gross value for Federal production, the proper way to read the regulation is as follows: "The gross value [of the Federal lease production] shall be the sale or contract unit price [of that production] times the number of units [of that production]" (See SOR at 11). San Juan alleges that MMS' interpretation of the regulation is erroneous because it, in effect, reads the regulation to state: "The gross value [of the Federal lease production] shall be the [weighted average] sale or contract unit price[s] [of all production from any source delivered to the purchasers under the sales agreement that also covers the Federal lease production to be valued] times the number of units [of Federal production] sold." Id.

5/ San Juan points out that although the applicable coal regulations generally fix the royalty basis at the price of Federal production, the oil and gas valuation regulations make price only one of several factors MMS considers when it determines value. See 30 CFR 250.64 (1980); 30 CFR 206.150 (1987).

Federal coal; it is purchasing coal for processing and resale as part of its Agreement with the Utilities. This procedure, San Juan claims, carries no royalty obligation of any kind.

In its answer, MMS contends the valuation method it utilized is consistent with the regulations and should be affirmed. MMS argues:

> The Fruitland coal was co-mingled with the purchased coal prior to sale and a unit price was received for the co-mingled coal. San Juan did not receive a separate unit price for the Fruitland coal and a separate unit price for the purchased coal. The unit price consisted of the total cost to San Juan plus an efficiency factor which was calculated based on the total cost of delivered coal compared to other coal sales. Thus, the unit price for the Fruitland coal was a composite of a number of factors some of which the sales agreement does not allocate to each source of coal. (Additionally, it is not practical to allocate these factors to each source of coal.) MMS multiplied this unit price times the number of federal units sold to arrive at royalty value. [Emphasis in original.]

(Answer at 5).

MMS states that it is common practice in the coal industry for coal from many sources to be sold under a single contract at a "single sales price per unit, as it was here" (Answer at 5-6). In such a situation, MMS asserts, value is what the purchaser is willing to pay for the total coal mix delivered under an arm's-length contract.

In reply, San Juan challenges MMS' total unit price argument asserting that MMS' statement that "a unit price was received for the co-mmingled coal" is "simply false" (Reply at 2). There was no single or unified unit price for all coal delivered under the Agreement, San Juan contends. It explains:

> Paragraph 9 of the coal supply agreement is clear--San Juan billed the Utilities a sum, not a unit price, each month. This was the result of adding together the separate amounts the Utilities owed San Juan under each pricing provision of the coal supply agreement * * *. San Juan could have sent separate invoices for the amount owed under each of these four subparagraphs of the contract.

Id.

San Juan also questions MMS' introduction of the "efficiency element," paragraph 9.6 of the Agreement, at this stage of the proceedings, claiming that the efficiency element was not relied on in either the RMP order or the Director's decision. San Juan asserts that MMS' efficiency element argument must fail. San Juan asserts that, as a practical matter, "San Juan has never billed the Utilities under 9.6 and has never received any revenue

under 9.6 * * *" (Reply at 3). Even if it had received revenue under paragraph 9.6, San Juan contends that MMS' assertion that allocation back to each source of coal "is not practical," is "strikingly wrong" (Reply at 4). San Juan explains that "[n]ot only is the math incredibly simple, in fact this type of allocation is precisely what San Juan did with its proceeds under 9.5 (coal processing pricing) without any objection from MMS in the course of the audit and billing that gave rise to this appeal." Id. at 4-5.

San Juan disputes MMS' assertion that this case involved a "single sales price per unit." Whether or not such contracts are common practice in the coal industry, San Juan contends, is irrelevant because the Agreement in this case does not establish a single sales price for all coal delivered under the contract. What the Utilities were willing to pay for Fruitland lease coal, San Juan argues, was "an entirely different price than the price the Utilities were willing to pay for non-San Juan coal" (Reply at 6).

[1] This case involves the question of the proper determination for gross value of coal production from the Federal leases in question, under an arm's-length contract, during the period 1980-86. The controlling regulatory language is: "The gross value shall be the sale or contract unit price times the number of units sold." 30 CFR 211.63(b) (1981); 30 CFR 203.200(g) (1984). Paragraph 9.1 of the Agreement provides that "[t]he sales price for coal delivered to Utilities under this Agreement shall be equal to the sum of" certain pricing components and an efficiency element.

MMS' position is that San Juan is to receive a total sales price for all coal sold under the Agreement, regardless of its source. That price is to be the sum of all the pricing components, which when divided by the total tons of coal delivered under the Agreement, yields the sale or contract unit price. To calculate royalty, MMS merely multiplied that sale or unit price times the number of tons of Federal coal sold. On the other hand, San Juan strenuously argues that the contract is divisible into its separate pricing components and that the only correct way to calculate the royalty on Federal production is to apply the Fruitland lease pricing provision (paragraph 9.2) to the Federal production.

We are convinced by our review of the record and the pleadings filed by the parties that San Juan's interpretation of the controlling regulation and the Agreement not only provides a reasonable basis for valuing the subject coal, it is also the correct interpretation. We, therefore, reverse the Director's decision.

[2] Under MMS' interpretation of the regulatory term "sale or con-tract unit price," San Juan is required to value coal production from these Federal leases on a basis that includes the price received for that coal, as well as the price received for other coal that is not mined by San Juan, but is purchased and processed for resale by San Juan under the Agreement. MMS' rationale for requiring such a valuation is that Federal coal is commingled with the purchased coal prior to sale and a unit price received for the commingled coal. This rationale, however, is persuasively rebutted by San Juan.

According to San Juan, this is not a situation where it is difficult to calculate the price of Federal coal production under the leases in issue. In fact, on a monthly basis San Juan calculated the "sale or contract unit price" for coal delivered under each separate pricing component of the Agreement, and it then billed the Utilities a sum, termed the "sales price" under the Agreement, not a unit price, for all the coal delivered. We agree with San Juan that what MMS is demanding is the calculation of a weighted average price for all coal delivered under the Agreement. There is no supportable rationale for requiring royalty valuation on that basis under the express terms of the Agreement involved in this case. Clearly, the Agreement is divisible for purposes of determining royalty on the Federal lease production. This is not a situation in which the Utilities agreed to pay a specific per ton amount for all coal delivered under the Agreement; rather, they agreed to pay a sum, billed by San Juan, based on its calculation of a "sale or contract unit price" for each of the sources of coal in accordance with the individual pricing components of the Agreement. Thus, what the Utilities agreed to pay for Sunbelt coal was different from what they agreed to pay for Fruitland coal. The computation under paragraph 9.2 of the Agreement produced the "sale or unit contract price" of the Fruitland lease production.

MMS' attempt, on appeal, to present the efficiency element as a justification for its valuation does not withstand the arguments set forth by San Juan in its reply. San Juan represents, without objection by MMS, that San Juan has never billed the Utilities under the efficiency element provision of the Agreement, and even if it did, such a billing could be allocated to the various coal sources for billing purposes, just as it allocates costs pursuant to paragraph 9.5 of the Agreement. 6/

As San Juan points out, the Director's rationale for overturning the RMP order regarding the imposition of royalty on the ash disposal costs related to the fact that San Juan had no legal obligation, as a Federal lessee, to dispose of the ash created by the Utilities. Ash disposal was a contractual obligation undertaken pursuant to the Agreement; it was not an obligation under the Federal leases. Therefore, the compensation San Juan received for doing so was not a reimbursement for operating costs. Likewise, the delivery of Sunbelt coal under the Agreement resulted in payments to San Juan that were unrelated to its mining, processing, pricing, and delivery of Federal coal. Because of the nature of the Agreement in this case, which contained separate pricing provisions for Fruitland lease coal and Sunbelt coal, San Juan's processing and resale service results in no Federal royalty obligation. 7/

6/ Added to the price derived under the paragraph 9.2 computation was the proper processing revenue allocation calculated under paragraph 9.5. San Juan states, and MMS does not dispute, that MMS did not challenge the method by which San Juan allocated those revenues among the various coal sources.

7/ Because we conclude that MMS' valuation in this case was erroneous, we need not address San Juan's arguments relating to the scope of review by the Director or this Board.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is reversed.

Bruce R. Harris

Deputy Chief Administrative Judge

I concur:

David L. Hughes
Administrative Judge